DOW THEORY LETTERS INC.

RICHARD RUSSELL
P.O. Box 15428
San Diego, Calif. 92115

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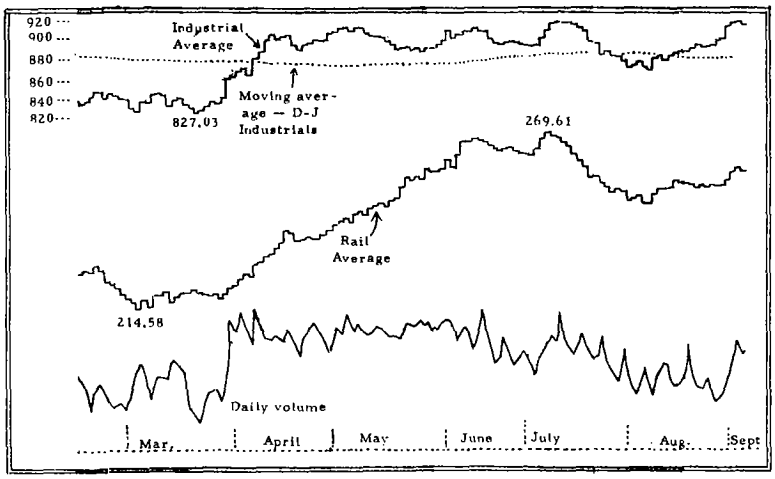
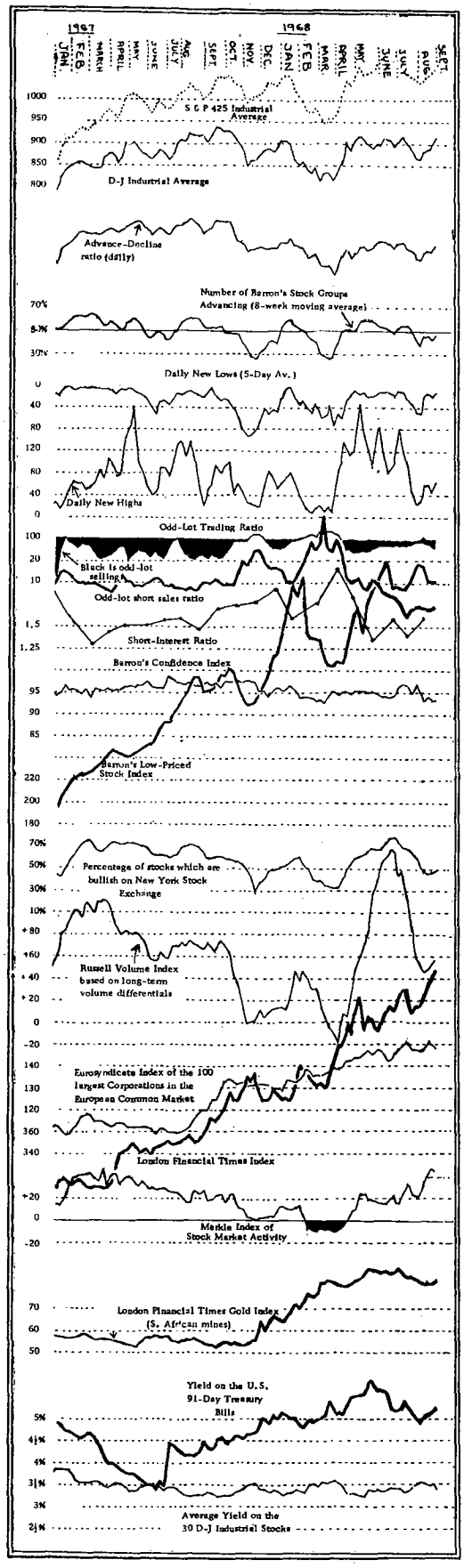
THE MARKET: Thirty-six months have passed since the February 9, 1966 peak (995.15) in the Dow Jones Industrial Average. The bear market began on February 10, and the first major leg down took the Dow to 744.32 in October of 1966. Since that date we have been embroiled in the most deceptive, the most frantic, the most explosive bear market recovery in the annals of the N.Y.S.E.

A review of past market history indicates that whenever a primary movement is held back or interrupted for any reason, the ultimate resumption of the main primary movement is that much more powerful. For instance, a bear market began in November, 1905, but due to the San Francisco earthquake (and the huge construction activity connected with the rebuilding of that city), the market held up all during 1906. When the primary bear trend took hold during the following year, it led to the smashing collapse known as the "Panic of 1907." Conversely, the great 1949-66 bull market was interrupted by a violent series of secondary reactions during 1956 and 1957. During late-1957 the final panic decline occurred amid the frightening news of Russia's Sputnik. When the primary bull trend finally took hold during late-1957 the advance was relentless and persistent. With one of the greatest short squeezes on record taking place, the Averages established new highs during late-1958, then went on to hit successive record highs throughout 1959 and into early 1960.

To get back to the present, the 23 months since the October, 1966 bear market lows, is one of the longest interruptions of a primary movement in market history. Adding to the fuel is the fact that the rise since the 1966 lows has been accompanied by the greatest volume and probably the wildest speculation on record. I feel that this market could hold up until after elections or that it could top out any day or week. But because of what has occurred since October, 1966, I also believe that the resumption of the primary bear market is fated to be one of the worst slaughters ever seen on the N.Y.S.E.

For the benefit of new subscribers, I might repeat that bear markets (like bull markets) are divided into three psychological phases. The first phase is the one (just following the preceding bull market top) in which stocks sell




1967
1968
JAN. FEB. MARCH APRIL MAY JUNE JULY AUG. SEPT. OCT. NOV. DEC. JAN. FEB. MARCH APRIL MAY JUNE JULY AUG. SEPT.
S & P 425 Industrial Average
D-J Industrial Average
Advance-Decline ratio (daily)
Number of Barron's Stock Groups Advancing (8-week moving average)
Daily New Lows (5-Day Av.)
Daily New Highs
Odd-Lot Trading Ratio
Black is odd-lot selling
Odd-lot short sales ratio
Short-Interest Ratio
Barron's Confidence Index
Barron's Low-Priced Stock Index
Percentage of stocks which are bullish on New York Stock Exchange
Russell Volume Index based on long-term volume differentials
Eurosyndicate Index of the 100 largest Corporations in the European Common Market
London Financial Times Index
Merkle Index of Stock Market Activity
London Financial Times Gold Index (S. African mines)
Yield on the U.S. 91-Day Treasury Bills
Average Yield on the 30 D-J Industrial Stocks

minus the hopes and froth of the preceding bull market's final speculative phase. This is what occurred during February to October, 1966. The second phase is almost always the most deceptive phase, and it is here that stocks ultimately decline in response to deteriorating business conditions and a generally disappointing outlook for corporate securities. By my reckoning, we are still in the second phase, but the disappointments have not yet appeared. Despite the 10% surtax, despite monetary crises, despite the loss of huge quantities of gold, despite every type of social and economic unrest, this market has preferred to discount inflation, fat corporate profits and continued high economic activity.

Nevertheless, in the face of the erosion of the dollar and the continuance of expanded corporate profits, the Dow Industrial Average has persistently failed to better either its 1967 peak of 943.08 or its 1966 peak of 995.15. The moment of truth is drawing ever closer, and when it arrives I believe panic will envelope the Exchanges of the world.

The third or final phase will occur after the current second phase is completed. In this third phase stocks will drift off on low volume as they sink below known values. Wall Street will then be the gatherer of millions of shares which have been distributed to amateur investors, and the old adage will rule again, "In the end, stocks always come back to the Street."

Near the end of the third phase I expect that those who have money will be in a position to garner the greatest bargain in share values in a generation. At that time I fully expect blue-chip, glamour and growth stocks to sell at yields of from 6% to 10%, much as they did during 1942 and 1949. It all sounds impossible here in 1968, but remember, during 1950 the possibility of the Dow going over the old 1929 high of 381.11 seemed just as impossible.

* * * *

On September 9 the Industrial Average rallied to a new 1968 high at 924.98, slightly above the July peak of 923.72. The same day found the Rail Average far below its own 1968 peak of 269.21 (see page 1 chart). The advance-decline ratio, too, failed to get near its July peak. Significantly (see later section), new highs for the day touched 78, a far cry from the 272 new highs recorded on June 7, the strongest day of 1968.

As this Letter is written the market is starting to churn with the pleurality of advances over declines beginning to peter out, with the Rails lagging and the Utility Average turning sluggish again. I would guess that the best part of the rally is near or at an end.

NEW HIGHS AND LOWS: One of the technical indicators which I watch closely is the Daily High-Low graph. To smooth out the action of this index, I have placed both daily highs and lows on a 5-day moving average (see chart, page 3).

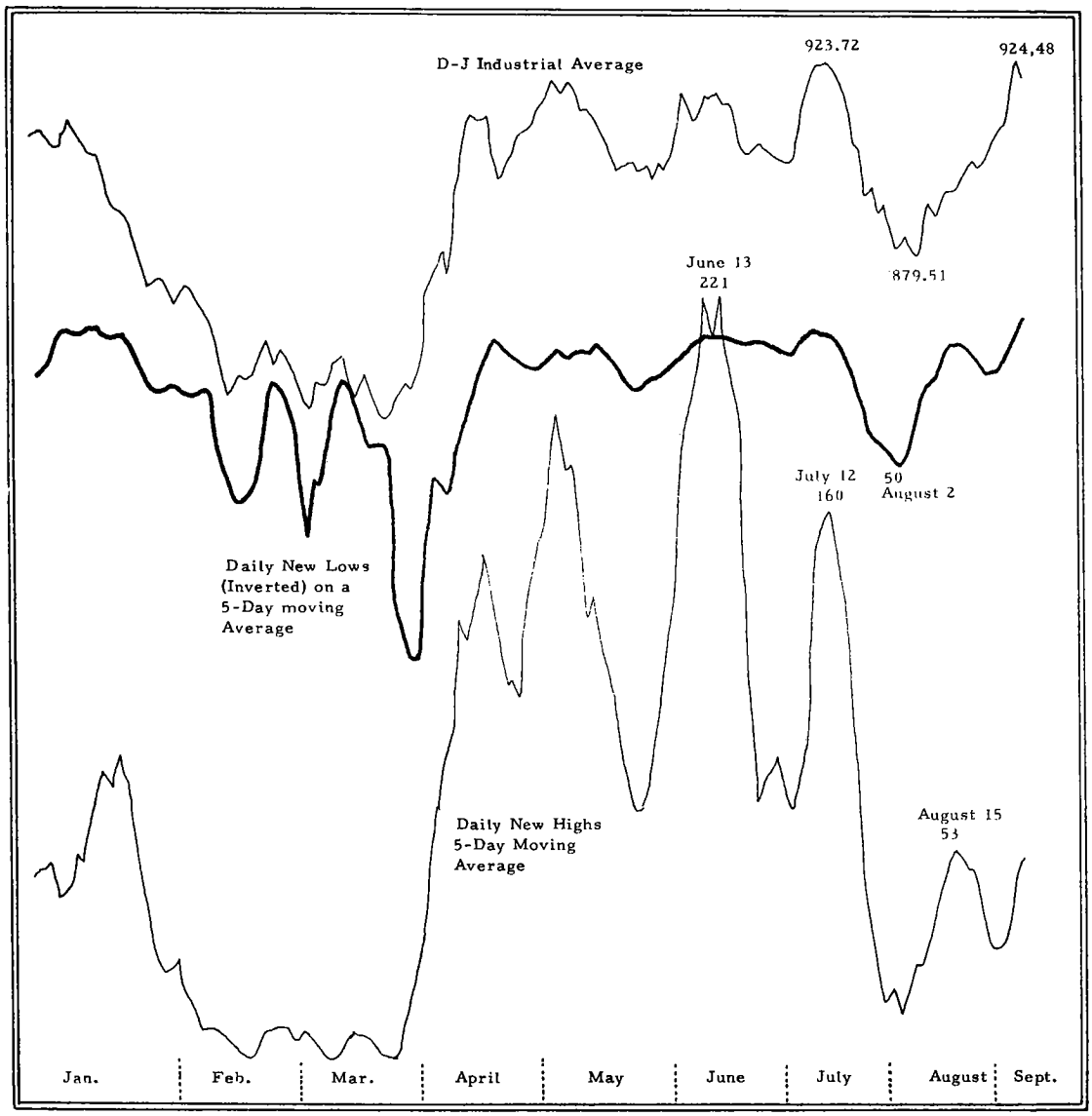
During a powerful advance (of the type which is sustained), it is normal for many stocks to push to new highs for the year. Then as more and more buyers enter the market, the original new high issues hold at or near their peaks while other stocks rally to join the new high parade. Such action is bullish, and it can be identified by a steady upward bias in the new high index accompanied by a succession of highs in the Averages.

On the other hand, if a rally is selective (and of the short-lived variety), it will be characterized by a handful of stocks touching new highs, then dropping back or perhaps collapsing as buyers switch their money into group after group. Such action will produce a rather sluggish pattern in the new high index—even though one or both Averages are rallying to new highs. This type of movement, a succession of highs in the Averages accompanied by a lagging pattern in the new high index, is generally a sign of weakness in the market. Extreme selectivity during a market advance is never a positive sign as is broad participation, and broad participation should always produce a series of ascending peaks in the new high index.

In view of this, the accompanying chart is worth studying. Note that on the rally from the March lows, the new high index did expand as new lows contracted. On June 13, as measured by the new high index, the market touched its peak of strength. On that day buying was strong enough to push the new high index to a 1968 peak of 221. A general market decline ensued, and during the decline the new low index (inverted) expanded only slightly, indicating a decided lack of selling pressure.

Another market advance took place, and this time the Dow Industrials rallied to a high of 923.72. This peak was not confirmed by the new high index, and as seen on the chart new highs reached only 160 on July 12. Another decline followed, and this time weakness did enter the market. The new low index expanded to a four-month peak of 50, highest since the March lows.

The current rally ensued, and this rally should be watched closely. So far on the rally, the new high index has established a peak (5-day moving average) of 61, this on September 9. Yet with the Dow above its previous



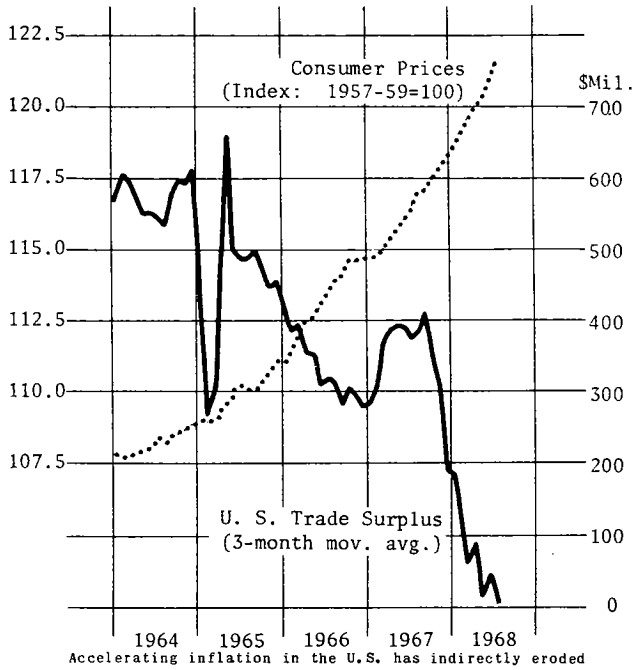
1968 high of 923.72, the new high index is far below its earlier (June 13) pinnacle of 221. My only conclusion is that so far, the rally lacks anything like the strength of the April-June rally. Rallies which are extremely selective (i.e. rallies that produce few new highs) are seldom sustained for long. At this writing, the new high index is throwing doubts on the strength or staying power of the current advance.

WHAT'S HAPPENING? On almost every front the monetary situation is heating up to white hot proportions. Last week France removed exchange controls, this after losing over 1/3 of their total reserves since the May strike. The French franc has been selling at a 10% to 15% discount on the foreign markets. It is possible that France has removed exchange controls to prepare for a devaluation of the franc. By law, a nation must ask permission of the I.M.F. prior to a devaluation, but removal of exchange controls could open the dikes for a massive flight out of francs. If this occurs, devaluation of the franc would be an utter necessity.

In Germany, mountains of dollars and other currencies have been descending on the country as speculators take positions prior to a possible upward re-valuation of the mark. Germany cannot accept unlimited carloads of dollars. If pressed (and it could be happening now), a portion of these dollars will be turned in to the U.S. for gold. Thus, a new "call" on U.S. gold appears, and as long as rumors of a mark re-valuation persist, U.S. gold stocks will be threatened.

The U.S. is in a quandary because if the dollar is to hold, the U.S. will have to supply gold to Germany. With only $10.6 billion remaining in the U.S. gold reserves, we can hardly afford a new outflow. Furthermore, U.S. deficit

continues to mount with foreign claims already at $32 billion. The accompanying chart shows what is occurring in the most favorable segment of the U.S. balance-of-payments picture, the trade surplus. This chart (courtesy of Holt Investment Advisory) shows the surplus dwindling to almost nothing in the face of galloping price inflation. The way it is going, the U.S. may end the year with a surplus of under $1 billion, instead of the $4 billion surplus that was originally planned for. All of which hardly puts the U.S. in a position to ward off, much less help, in the event of an international monetary crisis.

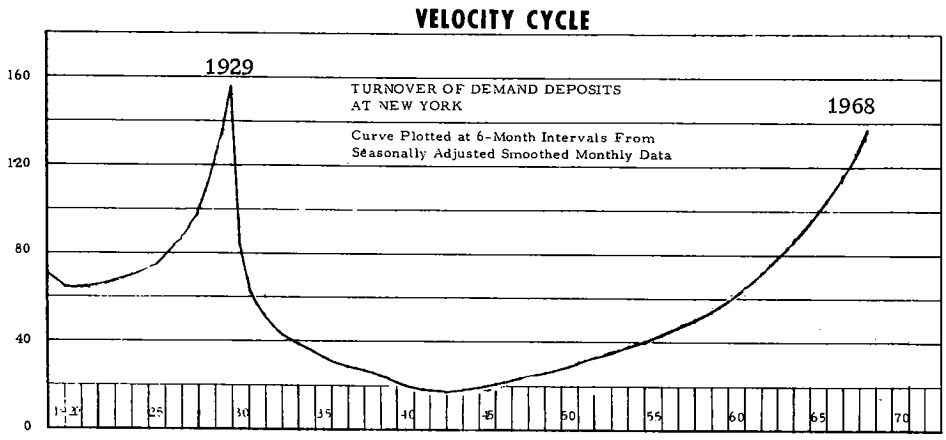


Accelerating inflation in the U.S. has indirectly eroded the nation's trade surplus. To meet foreign demands that a fundamental improvement in the payments situation be achieved, the Fed must act to dampen the economy, even at the risk of a recession.

Finally, on September 9 Britain negotiated a $2 billion loan from 12 nations meeting at Basel. The loan is a last desperate attempt by the rest of the world to get Britain off the hook and to get the pound out of the way as a reserve currency. The pound is to be gradually phased out as a reserve, a process which has been occurring anyway. As mentioned before, Britain had run a $100 million a month deficit during 1967, prior to the November devaluation of the pound from $2.80 to $2.40. During 1968, despite the 1967 devaluation, Britain has been running a $200 million a month deficit, and in the face of this disastrous situation Britain's creditors have announced that they have "had enough." The new loan is a way of trying to hold up the pound while pound holders bail out. All of which leaves dollars and gold as the only Free World reserves. This also means that the dollar will be more important than ever, since it will be the world's only currency reserve.

Thus, I have outlined a few of the problems which confront the world from the monetary standpoint. The crisis could come from a full development of any of the situations described above. And any crisis in one nation could immediately touch off a crisis in a second and third country. I will repeat, I believe it is from the monetary sector that the trouble for Wall Street will arrive. The hour is growing late.

FRENZY: I have reproduced here a chart from the latest issue of the Bolton-Tremblay Bank Credit Analyst. This chart traces the velocity of turnover of demand deposits (or total financial "activity") in the nation's leading financial center, New York City. The chart is particularly interesting since it goes back to 1919, thereby providing perspective for one half a century of financial activity in New York.



As a rule, when interest rates rise (when it is expensive to buy money) and when the credit base becomes strained (low individual and corporate reserves) and when financial and speculative activity is expanding, the velocity of turnover of demand deposits spirals upwards.

Since the chart shows demand deposit velocity as a rising curve of activity, there must obviously be a point of no-return. Otherwise the 1929 situation, for instance might have continued forever with (for the sake of exaggeration) all the demand deposits in N.Y.C. ultimately turning over every hour— a rather impossible situation.

What did occur was that financial activity reached a "white hot" level in N.Y.C. during 1929, perhaps due to the fact that stock margins were as low as 10% during that year. Demand velocity (see chart) during 1929 reached the incredible figure of 156, and then the structure toppled. As business slowed and checking accounts stagnated, the turnover continued to drop. By the early 1940's, velocity had sunk below the 50 level, fully two-thirds under the 1929 peak!

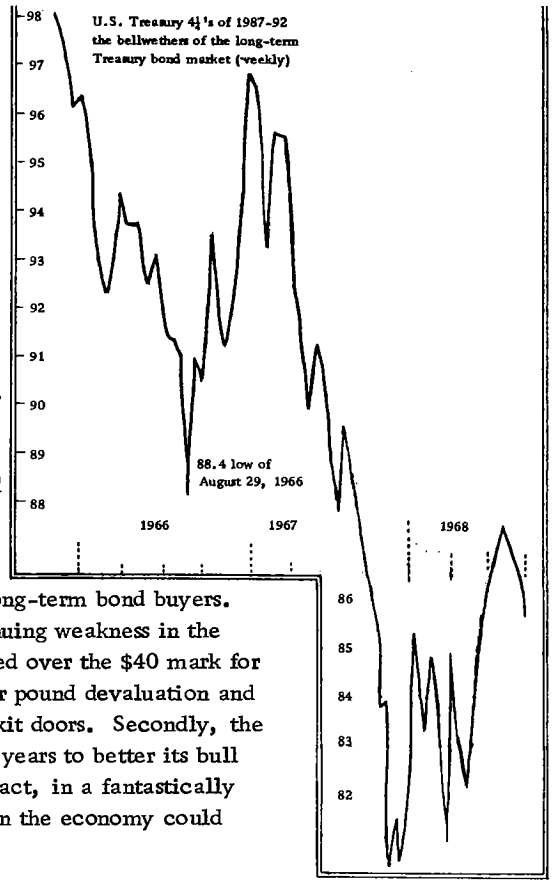
During the 1950's and 1960's demand deposit velocity again pushed upward as speculation increased and as the credid base was expanded. The velocity curve has steadily increased up to last month's high of 140.3, the highest level since 1929. This speed-up in velocity is not a gauge which says "danger" at some precise level such as 140 or 150. What the velocity chart is saying is that the whole financial situation is becoming increasingly vulnerable, and that the point of no-return is drawing ever closer. Will it top out before 1929's figure of 156—or will it go higher? No one knows, but it is probable that the current velocity spiral will end either with a collapse in the international monetary structure or a collapse in the American or world economy.

Mr. Donald R. Storey, editor of the Bank Credit Analyst notes in the current issue of that publication that part of the problem stems from the fact that world price levels are becoming increasingly out of kilter with the current depressed price of gold. In the event of a financial collapse and a decline in the velocity cycle, states Storey, "....the pressure to raise the price of gold will be powerful, as a bail-out measure at the time of panic. If deflation develops, there would be increasing pressure to raise the price of gold to reverse this process and restore some sort of equilibrium with price levels."

As I see it then, the velocity cycle as shown on this chart is one of the "time bombs" which is relentlessly ticking away. At some point in the future, the bomb will go off, and the whole economic process will start decelerating. That emergency will set off a cry for a great expansion in the credit base. The expansion will most likely be attempted by a rise in the gold price. The time of such an emergency (if I have to hazard such a guess) is coming during 1969.

BONDS: With the easing of the gold crisis following the May, 1968 run-up in gold to over $42 per ounce in London, the bond market embarked on a sustained rally. Opinion, in general was divided into two camps. The optimistic camp believed that the two-tier gold system plus the advent of the increased drawing rights via S.D.R.'s meant that the worst had been seen. It would be only a matter of time, they felt, until gold was reduced in importance as a reserve, and therefore the money markets had passed their period of greatest strain.

The second group also believed that the money markets had seen the worst—but for a different reason. This less optimistic group believed that the economy had passed its peak of activity, and that with slowly gathering recessionary conditions, the need for money would decline, thus taking the pressure off interest rates and the money markets in general.



Personally, I do not subscribe to either of these concepts. I have included a chart of the bellwether of the U.S. Treasury bond market, the 4¼'s of 1987-92. This is the bond that most traders watch (much as stock market analysts watch General Motors) for clues as to the next direction of the bond market.

Note the sharp rally from the 81 area of May, 1968 to the high of almost 88 in early August. From the August high, the 4¼'s have dropped back to last week's low of 85 20/32nds. Seen in perspective, the 4¼ bonds on the entire rally since the 1967 low of 79 18/32nds have recovered less than half their losses from the 1966 high. I continue to be unimpressed by the rally in the bond market.

My own guess is that two factors are worrying sophisticated long-term bond buyers. First, the price of gold will not stay down. Reflecting continuing weakness in the pound, the price of gold in London last week actually pushed over the $40 mark for the first time since early July. Thus the possibility of another pound devaluation and an international monetary crisis keeps bond buyers near the exit doors. Secondly, the failure of the Dow Industrial Average after two-and-one-half years to better its bull market high presents the constant possibility that we are, in fact, in a fantastically deceptive rally in a primary bear market. If this is true, then the economy could turn down at any time.

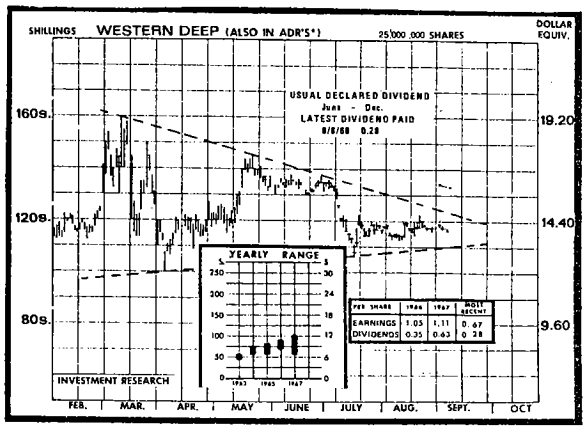
If the U.S. economy was strong, reason bond buyers, then why is the dollar again selling at a wide discount in terms of the price of gold in London. A rock-hard dollar,

backed by sufficient gold, would sell at or near $35 per ounce. Yet since mid-July the trend of the price of gold has been up, and this worries bond buyers. But a final possibility looms as the scariest of all. If a crisis does hit and if business does turn down, it will mean that tax receipts will also shrink. Few people are aware of the disastrous consequences of slipping tax receipts in the face of the gigantic spending programs which are built into this nation. Aside from the astronomical cost of servicing the national debt at almost record interest rates, we face a continued Vietnam war and the largest domestic spending programs in history.

Few believe that expenses are going to be cut over the foreseeable future, and therefore the only thing that is holding this nation and its debt together is booming business and booming tax receipts. Should business run into any trouble thereby cutting Government tax receipts we could expect a massive collapse in the bond market— since it would be to the bond market that the Government would turn in an attempt to keep its income up. Between 1929 and 1932 the Government's tax receipts dropped almost 50%. Can you imagine what a drop of even 10% would mean now?

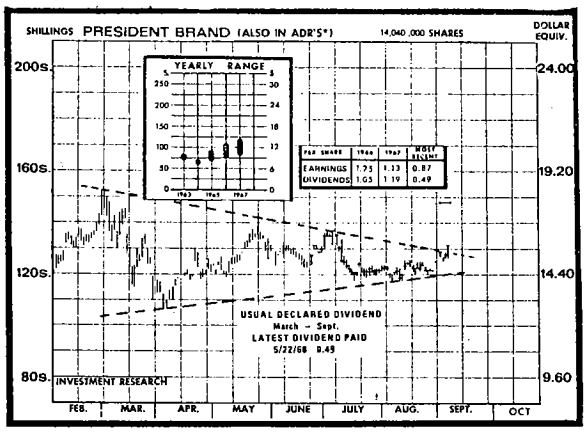
DOW THEORY MARKET LABORATORY PAGE

In the last few Letters I drew particular attention to both the trend of the price of gold and the gathering strength in the gold stocks. It was pointed out that most of the gold shares listed on the N.Y.S.E. were in the process of forming bases, and that I expected upside action in the gold shares soon.



Last week strength did indeed come into the gold shares. At Tuesday's (September 9) closing, the four listed gold issues, Amer. S. African, Dome, Campbell and Homestake, had pushed out of good bases to four month highs. At the same time, the dollar price of gold in London stayed persistently above $40.00.

What of the South African mines, what is going on with the really great gold producers of the Western World? I include charts of two typical and leading S. African gold mines, Western-Deep and President Brand. These charts are from the new Kaffir Chart Service, an excellent and unique service put out by Indicator Chart Service, Palisades Park, New Jersey 07650.



Here we note large consolidation triangles with descending tops and ascending bottoms. As a rule, such formations denote fairly equal buying and selling with neither the bulls or the bears getting the best of the argument. Generally, the final breakout from such a formation indicates the main direction which these stocks will take.

Last week President Brand started to push out of its triangle on the upside, and this must be taken as a hopeful sign. In so doing, President rallied to its highest price since early July. Western Deep is still fluctuating within its triangle, and it will be interesting to see whether Western (and other S. African issues) follow President Brand to the upside. At any rate, we have strength in the price of gold, strength in the listed N.Y.S.E. issues, and the beginning of strength in a few S. African gold shares.